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TAGS: EFIN ECON EINV CH
SUBJECT: SHANGHAI STOCK MARKET: UP, UP, AND A BUMP: WHERE TO NEXT?

REF: A. 07 SHANGHAI 25
¶B. 07 SHANGHAI 325
¶C. 07 BEIJING 7554
¶D. 07 SHANGHAI 777

SHANGHAI 00000028 001.2 OF 003

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¶1. (SBU) Summary: The Shanghai Stock Exchange (SSE) rose 97 percent in 2007, adding to its 130 percent gain in 2006. The market was characterized by volatility and sharp swings. However, at the close of business in 2007, two-thirds of stocks listed were at historical highs and local investor confidence over the mid-term remains high. Concern about the effects of a possible economic downtown in the United States and the subprime mortgage crisis contributed to a more than 20 percent drop in the market's value from January 15 to 22 of 2008. Institutional investors and market analysts outlook for 2008 were mixed with some predicting a crash and others predicting gains of as much as 50 percent. Retail investors remain convinced that the Chinese Government will support the market's value during this politically important Olympic year. End summary.

Shanghai Stock Exchange Up 97 Percent in 2007

¶2. (SBU) The Shanghai Stock Exchange (SSE), as measured by the Shanghai Composite Index (SCI), closed at 5261 points on the last trading day of 2007, 97 percent higher than on its first day of trading in January 2007. This annual gain came on the heels of its 130 percent gain in 2006 that was sparked by the success of China's non-tradable share reform and investor confidence. (Ref A) The SCI reached a record high of 6124 points on October 16, 2007.

¶3. (SBU) China's financial structure and over-liquidity were major factors contributing to individuals investing in the market despite the relatively high price to earnings (P/E)

ratios. Inflationary pressure, a real negative interest rate, closed capital markets, and ongoing RMB appreciation expectation led individuals with savings to invest them in the stock market in record numbers.

¶4. (SBU) Volatility in inter-day trading of Chinese A-shares increased in 2007 over 2006, most obviously in the second half of 2007 with the market bouncing up and down from week to week. Part of this increased volatility was in response to government policies, such as the doubling of stamp tax on trades. (Ref B) Other swings in trading were attributed to expected government policy and personnel changes as well as the fact that many retail investors still rely on the rumor mill for basic market information.

¶5. (SBU) Following the all-time market high on October 16, the market declined 20 percent over the following two months. By the middle of December 2007, the SCI started to rebound and by January 14, 2008 had once again passed through the 5500 point barrier. Two-thirds of listed companies were at historical highs. The average P/E ratio of stocks listed on the Shanghai Stock Exchange on January 14 was over 60, and the average P/E ratio for the small- and medium-sized company sector was 99.

2008: In Like a Bull, Out Like a Rat?

¶6. (SBU) From January 15 to 22, as international markets reacted to concerns with the subprime mortgage crisis and the possibility of weak economic performance in the United States, the SSE also slumped by 22 percent with the SCI losing almost 1,000 points. Consulate contacts in Shanghai attributed this slump to weak investor confidence and a reaction to the turmoil on the Hong Kong Stock Exchange and other non-Chinese bourses. Their concern is that a slowdown in the United States would spread to China, slowing economic and corporate profits growth.

¶7. (SBU) The January 22 SSE announcement that the "Bank of China failed to make a statement on an important event so trading in its shares will be suspended for all day on January 22," was seen by investors as strong evidence that the Bank of China has large, undeclared losses in its subprime mortgage portfolio. This prompted a seven percent market sell-off on January 22. Bank of China subsequently issued a statement that these reports were "groundless" and trading of its stock resumed on January ¶23.

¶8. (SBU) SSE Deputy Director Chao Kejian told Econoff on January 23 that while concerns about the effects on China's economy of a possible recession in the United States had "weakened" Chinese investor confidence, the sell-off was also driven by local factors. The People's Bank of China has been consistently raising interest rates, prompting some casual investors to increase their bank savings rather than invest in the market. Also, demand for cash is especially high going into the Chinese New Year season as it is traditional to give cash as gifts. (Note: The Year of the Rat begins on February 7. End note.) Investors are also holding off on putting more money into the markets until after the National People's Congress annual meeting in March as many expect major economic decisions and announcements to be made in that legislative session, he said.

¶9. (SBU) Shanghai Academy of Social Sciences (SASS) Institute of World Economy Deputy Director Professor Xu Mingqi told Econoff on January 24 that it appeared that the SSE's bull market had run its course. He expected that in 2008 the market would be characterized by volatility, with swings up and down as individual investors attempted to time the crash that Xu believes is inevitable in the later part of this year. Many, if not all, retail investors believe that the Chinese Government will support the market until the August Olympics in Beijing. As soon as it is no longer government policy to support the

market, it should settle down to a "more real level," Xu said.

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Institutional Investors Outlook: Mixed, Uncertain
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¶10. (SBU) Institutional investors' and industry analyst outlooks on the SSE in 2008 are mixed. Some representative views:

-- Haitong Securities Company Director Wu Bing is pessimistic about the market's future since he believes the market's growth over the last two years has gotten too far ahead of the companies' fundamentals. If stock prices remain about the same, he expects that it will take at least two years for company profits to rise to bring average P/E ratios down to a more reasonable level.

-- Lombarda China Fund Manager Ian Midgely said that he does not expect 2008 to be as "bumpy" as 2007 as there appears to be government support for the market between 4800 and 5000 points. As there are "currently no incentives for the government to have the market unravel," Midgely anticipates that whenever the market drops, there will be "favorable announcements" such as approving the launch of new funds or other market-supporting actions. He does not anticipate that the government will need to take any direct measures to maintain stability.

-- CITIC Fund Management Company Business Development Senior Vice President Peng Yan, noting the continuing over-liquidity problem in China, expects that the market will continue to advance in 2008.

-- SASS's Xu noted that since Chinese companies have only started to issue dividends to their stockholders, individual investors have traditionally had no way to benefit from holding shares in a profitable company except by selling their stock at a higher price than they paid. This means that the value of Chinese stocks only goes up as long as more money flows into the market, he said. Since there is a finite amount of money available to be invested, this means that eventually there will be a crash. He believes this crash is likely in 2008.

-- Shenyin & Wanguo Securities Company Manager Li Qinghai

remains bullish. Stressing the high growth in corporate earnings of listed companies, the positive effects of RMB appreciation encouraging inflows into RMB-denominated assets such as stocks, and the Beijing Olympics in August of 2008, he expects the market to continue to advance.

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RMB Appreciation, Inflation Both Good for Market
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¶11. (SBU) SSE's Chao expects that the SCI will continue to climb in 2008, but at a slower rate than in 2007. He said that SSE's own analysis expects that the market could rise by as much as 50 percent in 2008. He attributes this sanguine outlook to several "positive factors," including continued RMB appreciation and inflation. The ongoing appreciation of the Chinese currency is raising the value of Chinese assets and is directly leading to increases on the stock market. Inflation (Ref C) is having a similar effect as asset values increase so do the value of stocks.

¶12. (SBU) Chao says that the stock market index futures product will "definitely be introduced this year" and have a "negative" influence on the value of the SCI. (Ref D) He expects that the launch of the index futures product will "sharply affect the market," and it is this concern that has led to its launch-date being repeatedly postponed by policy-makers concerned about retail investor backlash. The needs of institutional investors to hedge their risks, however, mean that this futures product must be launched eventually.
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